The Tax Exemption under Section 501(c)(4)

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The Tax Exemption under Section 501(c)(4)

**Note to Readers:** Organizations exempt from tax under section 501(c)(4) of the Internal Revenue Code have achieved a great deal of notoriety lately as the go-to entity for political campaign expenditures for those seeking to avoid disclosure of contributors and possibly other non-tax rules applicable to PACs or political parties.

This draft was written before the public controversy concerning the IRS ruling process and before the announcement of proposed new guidance in November 2013. Further, it does not closely examine why lobbying and campaign activities are considered incompatible with charity. Nevertheless, it seems useful to make it available to the public since it provides a relatively unique examination of the underlying justification for complete tax exemption for 501(c)(4) organizations, in light of the absence of the charitable deduction and the evolving treatment of mutual organizations, particularly social clubs and political organizations.

This examination of the income tax exemption under section 501(c)(4) of the Internal Revenue Code is a continuation of a project to analyze the tax exemption for nonprofit organizations. My previous work dealt with charities and mutuals. We are all familiar with 501(c)(3) organizations, or charities, which offer contributors a charitable deduction. Many other organizations, which do not provide a charitable deduction, are also fully or partially exempt from tax. Most of these organizations are mutuals, as diverse as social clubs and trade associations, operated for the benefit of members. Section 501(c)(4) organizations are unique. Like charities, they are “public organizations” required to promote social welfare rather than the interests of their members; unlike charities, however, contributions to these organizations cannot be deducted. Should income, nevertheless, be exempt?

Some (notably Boris Bittker) have suggested that nonprofit entities may not be a proper subject for income taxation, which “could be appropriately imposed only on activities conducted for profit.” Others (notably Henry Hansmann) have disagreed and have sought to defend exemption as a subsidy. My prior articles suggested that there is not a simple answer to this inquiry. The conclusion depends very much on both the nature of the organization and the type of income at issue. In part, exemption is consistent with an income tax. In other cases, exemption amounts to special treatment or a subsidy. For charities I determined that a significant subsidy exists only with respect to the exemption for income from unrelated
investments and with respect to the treatment of income from related activities used for capital expenditures, such as buildings, as opposed to being used for expenditures which would be usually currently deducted.\textsuperscript{5} I concluded that, in most instances, a subsidy could be justified for charities.

However, mutuals, ideally, should not get special treatment. The Internal Revenue Code has never had a blanket exemption for all nonprofit organizations. The American Automobile Club, for example, has always been taxable. Full taxation has been extended to mutual savings banks and Blue Cross, which were at one time exempt. In 1969, Congress determined that social clubs should be taxable except for income from transactions with members. This approach has been applied to homeowner associations, cooperatives, and (possibly) political parties.\textsuperscript{6} I recommended further extension to all consumer mutuals—that is, circumstances where contributions to the organization would not be deductible business expenses. This would suggest full taxation of investment income for all such organizations, contrary to the approach now applied to (c)(3)s and (c)(4)s.

Here, I consider where section 501(c)(4) organizations fall.

**Section 501(c)(4)**

The world of section 501(c)(4) cannot be neatly described. The Internal Revenue Code defines these organizations as “civic leagues or organizations not operated for profit but operated exclusively for the promotion of social welfare.” In contrast to the regulations under section 501(c)(3) which allow only an “insubstantial” amount of nonqualifying activities,\textsuperscript{7} the 501(c)(4) regulations do not insist on exclusivity. These regulations provide that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the community, including an organization which is operated primarily for “the purpose of bringing about civic betterments and social improvements.”\textsuperscript{8} As we will see, this dichotomy in the definition of “exclusively” complicates the approach to 501(c)(4). While social welfare can be a charitable purpose under section 501(c)(3),\textsuperscript{9} apparently a social welfare organization would fail to qualify as a charitable organization for two totally separate reasons.

First, the regulations provide that an organization is disqualified under section 501(c)(3) if it engages in excessive lobbying or participates in any way in a political campaign. These so-called action organizations, however, can qualify under section 501(c)(4). The second and wholly unrelated category of social welfare organizations is not, in fact, described in the
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regulations, and its scope is quite murky to both the IRS and the commentators. Apparently, however, section 501(c)(4) has become a default option for organizations that provide some public benefit but either fail to provide sufficient community benefit to qualify under section 501(c)(3) or cannot so qualify because they carry on more than an incidental level of nonexempt activities, most likely benefits for members. These two conditions may well overlap.

The question is why the organizations described in the prior paragraph, which are deemed unworthy of the charitable contribution deduction, are nevertheless entitled to be exempt on income.

**Special Treatment Is Appropriate for Charities**

The charitable deduction is, of course, a significant subsidy, and if one assumes this subsidy is appropriate (which I did for the purpose of my earlier work), this signals that a subsidy exempting a charity’s income may be acceptable as well. But even this is not straightforward. As I have described in my earlier work, justifying the income tax exemption requires an additional showing that accumulation is appropriately treated. Thus, the charitable deduction reduces the cost of both current and future charitable outputs. An income tax exemption, on the other hand, will not, for the most part, reduce the cost of current operations. It will affect only the relative costs of setting aside funds for the future compared with providing current benefits. As such, unlike the charitable deduction, it will subsidize only those organizations that accumulate funds while denying any benefits to those which spend relatively quickly.

In fact, this subsidy can be surprisingly large, even exceeding the benefit of the charitable deduction for long-term accumulation. For example, due to the charitable deduction, a donor in a 35 percent bracket can purchase $100 worth of charitable services by forgoing $65 of private consumption from after-tax income (a price reduction of 35 percent). However, the discount increases if future personal consumption is compared to a current gift for future consumption by the charity. For example, assuming all income were fully and immediately taxed at ordinary income rates, if the individual neither spent the $65 on personal consumption nor made a charitable contribution, she would, if she earned 10 percent, have $69.23 available after one year. This would support a charitable contribution of $106.50 (again a 35 percent discount).

On the other hand, if the gift is made initially and the donee’s investment income is not taxed, the charity would have $110 after one year, while the donor is giving up just $69.23 of personal consumption at that time, effectively a discount of 37 percent. The discount would increase significantly as consumption is further delayed. After 30 years, nearly three times as
much can be accumulated at the charity level compared with personal savings or a discount of nearly two-thirds for the purchase of charitable goods at that time.

In sum, since investment income is normally taxed, the price reduction for future as opposed to current charitable spending holds steady if income is taxed to charities. But it increases, perhaps very significantly, if the charity’s investment income is exempt. If the accumulation period is long enough, the discount—that is, the cost of the goods and services eventually provided compared with the cost to taxable organizations—can be appreciably greater than the discount provided by the charitable deduction.

To put it simply, the tax exemption means that donors get more bang for the charitable buck if they give to an endowment rather than for current spending. Donors are, thus, incentivized to shift less of their current consumption and more of their future consumption to the charitable sector. This is particularly troubling if one believes that charitable accumulation is likely to be larger than public policy would judge desirable. I believe this seems likely for a number of reasons.\textsuperscript{15}

First, trustees, donors, and key employees likely have a bias in favor of accumulating funds, as opposed to current spending, which will not necessarily reflect the interest of the institution, let alone the public. Second, the apparent goal of these organizations to ensure continuation of the level of the contribution to program support from the endowment, without regard to market performance or the likelihood of future gifts, seems to me to unduly set aside current resources for use by future generations. Finally, there appears to be a tendency, or at least a desire, toward increasing the share of the budget provided from an endowment, perhaps to increase the competitive advantage of richer institutions, which again does not appear to reflect the public interest.\textsuperscript{16} Although I, nevertheless, found the current treatment of charities acceptable except in the case of a large endowment, this analysis suggests caution toward an exemption for investment income, particularly if accumulation is not limited to a short time or a small multiple of annual expenditures.

**Subsidy for Section 501(c)(4) Organizations**

Congress places 501(c)(4)s in the category of organizations providing public benefit rather than mutual organizations providing benefits solely to their members. Thus, like section 501(c)(3) organizations, and unlike mutuals, 501(c)(4)s are subject to the so-called nondistribution constraint in that, “no part of the net earnings ... inures to the benefit of any private shareholder
This, perhaps, suggests that Congress believes that section 501(c)(4) organizations may similarly be entitled to a subsidy in some circumstances.

However, the charitable deduction is not allowed. While, as discussed in the prior part, income tax exemption does not necessarily follow from the charitable deduction, the existence of a charitable deduction can be considered an indication that Congress thinks a subsidy could be justified. Would the absence of the charitable deduction signal that a subsidy in the form of an exemption for income is inappropriate? In this context, Section 501(c)(4) raises the question of whether there is any reason to subsidize only those organizations that accumulate funds while denying any benefits to those that spend relatively quickly? As noted, the latter would be helped by the charitable deduction but not by the income tax exemption.

It is difficult to think of a reason to intentionally limit a subsidy to organizations that accumulate. However, perhaps, not surprisingly, this effect is probably not well understood. It simply may be that a smaller subsidy seemed appropriate and the income tax exemption seems intuitively to be relatively unimportant compared with the charitable deduction. However, as just discussed, this assumption may be mistaken particularly for long-term accumulation.

Perhaps, however, the source of tax exemption for (c)(4)s is not that they are closely similar to charities but that they are at least as worthy as mutuals, many of which are exempt from tax. However, tax exemption for mutuals has been limited over the years, and investment income of mutuals is now taxed in many situations. Myself and others have suggested further narrowing of the exemption for investment income. With this in mind, I now turn to whether section 501(c)(4) organizations of various types deserve exemption for their income.

**Action Organizations—Lobbying**

Probably most (c)(4) organizations, at least until recently, are affiliates of section 501(c)(3)s organized to engage in unlimited lobbying. The regulations provide that an organization cannot qualify under section 501(c)(3) if it is a so-called action organization. An organization is an action organization if a “substantial part of its activities is attempting to influence legislation” or “its main or primary objective may be attained only by legislation or a defeat of proposed legislation and it advocates or campaigns for the attainment of such objective as distinguished from engaging in nonpartisan analysis or research and making the results thereof available to the public.” In contrast an action organization can qualify under section 501(c)(4) and may engage in unlimited lobbying. Thus, the IRS acknowledges that lobbying can promote social welfare.
The lobbying limitation dates back to a 1919 Treasury regulation, which provided that “associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute.” In 1930, the Second Circuit, in an opinion by Learned Hand, held that the American Birth Control League was not entitled to exemption because it had disseminated propaganda to legislators and the public supporting the repeal of laws against birth control. The court was troubled by the fact that legislation was central to the organization’s goal and indicated it might have approved lobbying which was ancillary to its mission. Judge Hand justified the decision by asserting the government should be neutral and not subsidize one-side of a political debate.

In *Regan v. Taxation with Representation of Washington*, the Supreme Court held that restrictions on lobbying were not unconstitutional since Congress is free to impose conditions on a subsidy—in this case, the charitable deduction. In a concurring opinion, Justice Blackmun emphasized that the Internal Revenue Service permitted a close relationship between a charity, exempt under section 501(c)(3), and a section 501(c)(4) affiliate that engaged in lobbying. Thus, an organization could lobby without losing any tax benefits for its non-lobbying activities. Blackmun’s opinion did not focus on whether the lobbying affiliate needs to be exempt from tax. Under the rationale of *Citizens United*, it is unclear that the Supreme Court would continue to view the costs of establishing and monitoring the relationship between two entities as benign.

Much has been written concerning the justification for lobbying restrictions, and I will not add to it here (at least at this time). It seems to me that the issue should be whether the organization is serving charitable and educational purposes. If so, lobbying would seem to be as legitimate as any other means of furthering the organization’s ends, and the lobbying limitation for 501(c)(3) organizations would be inappropriate. The charitable deduction amounts to government intervention regardless of the employed tactics, which now can include litigation, boycotts, picketing, and other legal activities. It is not obvious to me that lobbying is any different.

Under this view, the income tax exemption would seem welcome despite the apparent illogic in basing the size of the subsidy on the degree and length of accumulation. If, on the other hand, one believes that the lobbying restriction wisely limits the extent of the government’s involvement, it is hard to see why the income tax exemption is acceptable unless it is thought, perhaps mistakenly, that the benefit is too small to worry about. Possibly in the end it is just a way to “split the baby,” given the conflict of views on the issue. In any event, tax exemption for
long-term accumulation, which can come close to or exceed the value of the charitable
deduction, or accumulation, which is a large multiple of annual expenditures, is hard to justify if
the charitable deduction is not appropriate.

**Action Organizations—Political Activities**

An organization is also an “action” organization if it participates to any extent in a political
campaign. Again, if the purpose of the organization is to further such ends as improvement of
education or protection of the environment, it is unclear why participation in a political
campaign, to help to elect sympathetic candidates, is not a legitimate means to promote its
charitable purpose. Perhaps it is just too difficult to distinguish those organizations from
others serving the personal and economic interests of their contributors.

In any event, analysis of this issue faces a more complex slate than the treatment of
lobbying. First, the regulations under section 501(c)(4) provide that, unlike the case of lobbying,
social welfare does not include participation in a political campaign, presumably even if the goal
is clearly to further the charitable ends of the organization. Second, Congress has specifically
limited the tax exemption of organizations focused on campaign activities. In particular, it has
made their investment income taxable.

These actions suggest that political organizations are considered comparable to
membership organizations or mutuals (intended to achieve common ends) as opposed to
achieving a public purpose. Thus, in 1969 Congress limited the tax exemption for social clubs to
transactions with members. If homeowners on adjoining properties pool their resources in
order to build a tennis court, they have just moved funds from one pocket to another and have
not generated additional income. However, if the pooled funds are in a bank account earning
interest or they charge people in the neighborhood who use the courts, at least if the charge
exceeds a fair apportionment of expenses, they have generated income used to support personal
activity, income that should be taxable. Applying that rationale to a country club with hundreds
of members, who do not uniformly use the facility, has obvious difficulties, but it is essentially
the model adopted for social clubs. Transactions with members do not produce taxable income,
but transactions with nonmembers and investment income is taxable.

A similar approach is used for political parties and campaign committees. Thus, an
organization organized and operated primarily for accepting contributions or making
expenditures to influence the election of any individual to a public office is exempt on a limited
type of income, which, importantly, would not extend to investment income. Thus, political
organizations are exempt only on “exempt function income.” Exempt function income includes contributions, membership dues, proceeds from a political fundraising or entertainment event, proceeds from sale of political campaign materials not received in the ordinary course of a trade or business, and proceeds from bingo to the extent such amounts are used to influence an election.

However, the exemption for social clubs seems more narrowly limited to transactions with members. Income from bingo and entertainment events, at least, are conceivably akin to nonmember income in the case of a social club. Perhaps the exemption under section 527 should be narrowed to track more closely the treatment of social clubs. On the other hand, the tax treatment of political organizations is much less generous than full exemption under section 501(c)(4).

There has been considerable recent interest in the use of 501(c)(4) organizations to avoid the disclosure (and other) requirements applicable to political parties and PACs. This use also avoids the tax treatment under section 527. Since, as noted, participation in a political campaign is not considered promotion of social welfare, under Internal Revenue Service rulings such political activity is permissible only if it is not the organization’s primary activity. Therefore, the organization must assert that its primary activity is educational and does not amount to political campaign intervention. Organizations spend money on issue advertisements—for example, promoting limited government—that they claim are educational, not political, even though they promote or reject positions held by named candidates. This assertion that these organizations are primarily educational would be a surprise to many of us and has apparently come under attack from watchdog groups. The IRS’s position is unclear, but there have been reports of exemption denial, which some have claimed is politically motivated.

(At the moment) I will not deal with this issue here. I will focus on the possible difference between the income tax treatment under sections 501(c)(4) and 527. Congress has attempted to eliminate this distinction under section 527(f), whereby a 501(c)(4) organization that engages in political activities is subject to tax on the lesser of expenditures for such purpose or its investment income. Nevertheless, a section 501(c)(4) engaged in political activities may still be able to attain better tax treatment than available under section 527, which seems inappropriate.

Section 501(c)(4) organizations are subject to tax only on investment income. It also may be difficult to identify investment income used for campaign expenditures. To limit taxation, an organization may establish a separate segregated fund and limit the taxable income to the investment income of the segregated fund. Organizations can also earn and retain investment
income before quarterly transfers to political campaign organizations. More technically (I will limit the discussion of this issue in this draft), the exemption under section 527 is limited to **exempt function income used for an exempt function**. Therefore, both the form of the income and the type of expenditure are subject to sometimes technical tests, which would not arise under section 501(c)(4). Section 501(c)(4)s can have exempt income from other sources and can spend dollars in ways not qualifying as exempt function expenditures.

Ideally, section 501(c)(4) organizations engaged in campaign activity to any significant extent should be subject to the tax scheme of section 527. This seems harsh if one takes as given, that the primary function of the organization is actually the promotion of social welfare not involving either campaign activities or lobbying. It seems difficult to subject the entire income of the organization to the scheme of section 527 as long as the organization is allowed, and indeed required in order to retain the exemption, to mix political campaigning with other purposes.

**Insufficient Community Benefit**

Aside from being a haven for action organization, as discussed in the previous two sections, the contours of section 501(c)(4) are decidedly murky. In 2003 an IRS training manual put it this way (quoting a manual from more than 20 years earlier):

> Although the Service has been making an effort to refine and clarify this area, IRC 501(c)(4) remains in some degree a catch-all for presumptively beneficial non-profit organizations that resist classification under the other exempting provisions of the Code. Unfortunately, this condition exists because “social welfare” is inherently an abstruse concept that continues to defy precise definition.\(^{38}\)

The Service appears to believe that social welfare under section 501(c)(4) is less stringent than the similar concept that qualifies as charitable under section 501(c)(3). Thus, the Service found that a nonprofit organization with membership limited to the residents and business operators within a city block and formed to preserve and beautify the public areas in the block, thereby benefiting the community as a whole, in addition to enhancing the value of its members’ property rights, will not qualify for exemption under IRC 501(c)(3) but may qualify under IRC 501(c)(4).\(^{39}\) On the other hand, an organization formed for the beautification of an entire city is operated exclusively for charitable purposes and thus qualifies for tax-exempt status under IRC 501(c)(3).\(^{40}\)
There is no clear indication of how the line is drawn, and the revenue rulings just discussed are unusual in that one can find two similar organizations whose qualification status apparently depends on the size of the community benefited. In most cases, the Service rules that section 501(c)(4) is available without describing why 501(c)(3) is not.\textsuperscript{41}

Organizations with insufficient community benefit to qualify under section 501(c)(3) raise similar issues to those previously considered for action organizations engaged in lobbying. Denying the charitable deduction and allowing income tax exemption would seem illogical, in that the size of the subsidy depends on the degree and length of accumulation and is denied to those who spend immediately. Perhaps again, however, this point is not well understood and the income tax exemption is acceptable because it is believed, perhaps mistakenly, to be too small to worry about. As discussed below, if the exemption is seen to follow from the treatment of mutuals, it needs reexamination in light of the changes in that area.

Another set of rulings approving 501(c)(4) status reflect the distinction between (c)(3) and (c)(4) organizations, in that the latter can have more than an insubstantial level of nonexempt activities, as long as these activities are not primary. This is perhaps, most clear in a revenue ruling describing several types of garden clubs.\textsuperscript{42}

In that ruling, Situation 1 describes an organization that instructs the public on horticultural subjects and stimulates interest in the beautification of the geographic area. Such an organization can qualify under section 501(c)(3). Situation 2 is distinguished from Situation 1 in that the organization in Situation 2 conducts substantial, more than incidental, social functions not in furtherance of any purposes specified in section 501(c)(3). Accordingly, the organization does not qualify for exemption under section 501(c)(3). Still, even though social activities are more than incidental, because the organization is operated primarily to bring about civic betterment and social improvements and the social functions for the benefit, pleasure, and recreation of the members do not constitute its primary activity, the organization qualifies for exemption under section 501(c)(4). However, when social activities predominate, the organization can only seek exemption as a social club under section 501(c)(7).

How can this ruling be explained? In 1981 the Service stated:

In practice section 501(c)(4) has been used by both the courts and the Service as a haven for organizations that lack the essential characteristics of a taxable entity, but elude classification under other subparagraphs of section 501(c).\textsuperscript{43}

Thus, civic leagues that provide more than incidental benefits to members could be viewed as just another category of a mutual organization. If so, in light of the income tax
exemption extended to many mutual nonprofits, similar treatment for these section 501(c)(4)s would seem fairly straightforward. If both civic leagues and social clubs are exempt, an organization that is a hybrid of both should be as well. This could explain the exemption.

This position made sense before 1969, since social clubs were totally exempt from tax. However, now that social clubs are exempt only on transactions with members and are fully taxable on investment income, it is troublesome to allow full exemption to an organization that may spend just short of half its resources on social activities. It can no longer be said that such organizations “lack the essential characteristics of a taxable entity.” As noted above, I believe the exemption for all consumer mutuals should track the treatment of social clubs and be limited to transactions with those who might be considered members, so that investment income and income from nonmember transactions would be taxable.44

**Conclusion**

In light of the substantial changes to the rules for tax exemption, it is past time for section 501(c)(4) to be reconsidered. The treatment of organizations engaged in campaign activities should be more closely aligned with the treatment of political parties, which in turn should more closely track the treatment of social clubs. If the restrictions on lobbying are retained, the size of a permitted accumulation in an organization engaged in extensive lobbying should be limited. Section 501(c)(4)s that provide more than incidental benefits to members should be taxed like social clubs. The treatment of organizations that benefit too narrow a group should also be reexamined in this light. At the least, accumulation should be limited.
Notes


3 Mutuals at 134, quoting Bittker and Radhert, 85 Yale L.J. 399.


5 Charities at 285–86.

6 Mutuals at 136–40, 150–52.

7 Treas. Reg. § 1.501(c)(3)-1 (c)(2).


9 Compare Treas. Reg. § 1.501(c)(3)-1 (d)(2).

10 See note 38 below.

11 See, for example, I.R.S. Priv. Ltr. Rul. 201123047 (June 10, 2011).

12 Charities at 287-90.

13 If she invested the $65 of after-tax income to earn 10 percent, she would earn $6.50 before tax. After paying tax at 35 percent, she would have $69.23.

14 The tax savings from the contribution of $106.50 ($37.27) when added to the accumulation of $69.23 totals $106.50.


17 IRC §501(c)(4)(B).

18 Mutuals at 150, 155.


21 Treas. Reg. § 1.501(c)(4)-1 (a)(2)(ii)


23 Treas. Reg. 45, art.517 (1919 ed.).

24 Slee v. Commissioner 42 F.2d 184 (2d Cir. 1930).


27 See, for example, Brian Galle, “Charities in Politics: A Reappraisal,” 54 Wm & Mary L. Rev. xxx (2012).


31 IRC Section 527.

32 IRC Section 512(a)(3).

33 Political organizations include any party or other organization organized and operated primarily for the purpose of accepting contributions or making expenditures or both for an exempt function. An exempt function is influencing
the selection, nomination, election, or appointment of any individual to a public office or an office in a political organization.

34 Rev. Rul. 81-95, 1981-1 Cum Bull. 332.


36 See http://www.dailykos.com/story/2012/02/29/1069536/-IRS-questioning-tea-party-groups-tax-exempt-status

37 Section 527(f)(3).


41 See, for example, Rev. Rul. 75-386, 1975-2 C.B. 211 (activities include contracting for security patrols designed to increase public safety and reduce crime in the community). Rev. Rul. 78-69, 1978-1 C.B. 156. (organization formed by residents of a suburban community to provide bus transportation during rush hours between the community and the major employment center in a metropolitan area) Rev. Rul. 81-116, 1981-1 C.B. 333 (an organization whose membership is open to the community and that provides free parking to anyone visiting the city's downtown business district, is contributing to civic betterment by relieving congested parking conditions).


44 Id. at 150-51.